5

Rationalizing the Personal Tax and Transfer Payment Systems: The Quebec Experience and Prospects for Ontario

ASPECTS OF PERSONAL INCOME TAXATION IN ONTARIO

Ministry of Revenue

In 1991-92, the Ontario Ministry of Revenue reviewed several aspects of personal income taxation in Ontario. The review is comprised of six essays. They are:

1. Ontario PIT Administration by Revenue Canada, Taxation
2. The Federal-Provincial Tax Collection Agreement: How Ontario Receives Its Personal Income Tax
3. Personal Income Tax Coordination - The Federal-Provincial Tax Collection Agreements: An Analysis of the Finance Canada Discussion Paper
4. Changing Federal-Provincial Partnerships: A Comparison of the Terms and Provisions of the Canada-Quebec GST Agreement and the Federal-Provincial Tax Collection Agreement
5. Rationalizing the Personal Tax and Transfer Payment Systems: The Quebec Experience and Prospects for Ontario
6. A Compromise Solution: An Alternative to the Present Federal-Provincial Tax Collection Agreement and Establishment of a Separate Ontario PIT Administration

fniv

TABLE OF CONTENTS

PART III CHOICES FOR QUEBEC

PART IV CHALLENGES FOR ONTARIO

Preface

For many, contemplation of an integrated personal income tax and individual transfer payment system would seem to be an unusual consideration. At first glance, each component appears to have mutually exclusive principles, guiding philosophies, and purposes. Indeed, the initial driving forces underlying the creation of each component were based on very different political, economic and social imperatives.

It is equally true that the effects and realities of the past thirty years have clearly shown that the personal income tax and individual transfer payments systems have become inextricably related. While they continue to operate, for the most part, as independent entities, their political, economic and social consequences demand better rationalization and co-ordination.

This daunting task was undertaken by the government of Quebec through the publication in 1984 of its **White Paper on the Personal Tax and Transfer Systems**. Much of the content of this paper is based on the material contained in the White Paper and on the events which have followed since its release.

Should Ontario wish to consider a similar approach, it must be remembered that Quebec's responses to its challenges have transpired in an environment of policy freedom and autonomy not presently available to other provinces. In the tax policy arena, in particular, Quebec has unrestricted freedom to set its provincial policy and instruments as reflections of its changing political, economic and social priorities. Ontario, and the rest of the provinces, do not.

This essay examines Quebec's experience in making the two systems more compatible vis-a-vis social assistance level of beneficiaries and comparable tax-free income levels of taxpayers in meeting individual and family essential needs. The essay, while discussing the types and benefit level features of various social assistance programs, is not written as an evaluation of their merit. Such an evaluation is the responsibility of those who set social policy.

The essay considers the types and benefit level features of social programs solely from the standpoint of their administration in general, and vis-a-vis their administrative rationalization into the tax system, in particular. The bureaucratic and administrative challenges of instituting a more rationalized, or integrated, personal income tax and individual transfer payment system, are made more difficult by the, at times, competing (social) values of the two systems. The greater challenge is in harmonizing these values.

The essay's reference to social programs relates specifically to direct payments by governments to individuals as social assistance or income maintenance. Not included are social program transfers related to health and post-secondary education from the federal to provincial governments under Established Program Financing (EPF), or federal transfers to provinces under the Canada Assistance Plan (CAP) or Fiscal Stabilization program.

Definitionally, rationalization of the tax and individual transfer payment systems relates to the extent to which the two systems, using commonly-defined terms, eligibility criteria, and treatment of taxpayers' (or recipients') financial requirements for essential needs may be delivered through a common administrative framework. Tax and individual transfer payment systems which are delivered independently one of the other, but which are compatible on these bases, may be said to be harmonized.

Following an analysis of the Quebec experience, the dynamics of the challenge for Ontario are examined within the province's own environmental context. Clearly, any interest Ontario may have in rationalizing its personal income tax and individual transfer payment systems would face a much stiffer challenge than encountered by Quebec.

Eliminating some of the obstacles would require a re-examination of our federal-provincial relationship and introduction of significant changes to shared policy and program delivery features. Attention must also be given to potential or direct implications for Ontario under the umbrella of federal-provincial Established Programs Financing (EPF), the Canada Assistance Plan (CAP) and the Fiscal Stabilization program. These implications must, as well, be weighed within the context of ongoing federal-provincial discussions and negotiations on a redistribution of federal-provincial powers under a revised Canadian Constitution.

Quantitative and qualitative analysis should also be undertaken to provide data for making a fully-informed decision. Needless to say, the process of reaching a sound decision and establishing a strategic plan pose some considerable demands. Ultimately, the desired purpose(s) of the tax system in delivering the instruments of government policy to achieve its political agenda may be the single most important consideration in reaching the final decision.

PART 1

BACKGROUND

The Taxation Field

Principles

In its early years, the taxation system was designed for a basic purpose - to ensure financing of public expenditure. The combined revenue from individuals, enterprises and government corporations, and revenue from the sales of government goods and services, from other levels of government, and from returns on investments was equal to the totality of government expenditures. Such a balance ensured that governments did not spend more than the total of revenues received.

Today, the federal and provincial governments in Canada also use the personal income tax system as a means of promoting economic and social initiatives and as a vehicle for income redistribution. This is accomplished through the use of progressive tax rates, surtaxes, tax credits, exemptions and other tax preferences, which reduce the tax revenue liability which would otherwise apply. Collectively, tax preferences are known as "tax expenditures" since they represent revenue foregone.

Tax expenditures may be used as instruments of social or economic policy, and often are a more efficient means of achieving government objectives. In most cases, it is less costly for government to change tax liability within an existing tax administration system than it would be to establish a new administrative mechanism to redistribute revenues collected in a system free from tax expenditures. On the other hand, the use of tax expenditures negatively affects a tax system's principles of taxpayer equity and neutrality in several ways.

Within the tax system are several guiding taxation principles, which have long been accepted as fundamental tenets. To establish taxpayer equity (fairness), tax rates should be based on vertical and horizontal equity principles. Vertical equity is based on the taxpayer's ability to pay. Progressive tax rates exact a larger percentage of tax from those with higher incomes, based on a "fair share" approach. Horizontal equity ensures that those in equal circumstances are treated equally within the tax system.

Inherent as well are considerations of economic stabilization, income redistribution and administrative efficiency. Economic stabilization requires the maintenance of high employment, a reasonable degree of price stability, and the provision of an attractive environment for the location of economic agents and wealth creators necessary to ensure economic growth.

Income redistribution requires that the tax system be designed to ensure that each taxpayer is provided with sufficient income, shielded from taxation, to establish a minimum standard of living. Establishment of an efficient and effective tax administration produces a "fair" tax system, easily understood by taxpayers, and, thus, more likely to encourage compliance and reduce evasion.

For a more detailed review of these and other fundamental principles of taxation, refer to the descriptions in Appendix A.

Administration

Under the British North America (BNA) Act, both the federal and provincial governments have taxing powers. Provincial powers are limited to fields of direct taxation, while the federal government has powers of both direct and indirect taxation.

A very critical element of difference that bears on distinctions between Quebec's response to its challenges, and options available to Ontario, relates to the manner by which personal income taxes are collected in the two provinces.

For 50 years following Confederation, the provinces received federal subsidies as their main source of revenue. As a means of financing the costs of World War I, the federal government began to tax in the same fields as the provinces, which resulted in the creation of a tax "jungle" for governments and taxpayers alike.

To avoid the duplication and confusion created, the provinces agreed to absent themselves from direct taxation in the personal income tax field in exchange for a fixed percentage of federal personal income tax revenues collected. While most provinces signed these Tax Rental Agreements, Quebec was never a partner, and Ontario opted in only in 1954.

Growing provincial dissatisfaction with the Tax Rental Agreements led to the Tax Sharing Agreements of 1957. Under this arrangement, the provinces gained a share of revenues in the fields of corporate tax and succession duties, as well as an increase in the percentage of personal income taxes. Formulae for equalization and stabilization payments were also established.

At the 1960 federal-provincial conference, provinces began to demand a "fairer" share of federal tax revenues. In response to mounting pressures from the provinces, the federal government announced that, as of March 31, 1962, it was discontinuing the Tax Sharing Agreements. In their place, Tax Collection Agreements were introduced. Via these Agreements, all provinces, except Quebec, have their provincial personal income taxes collected on their behalf by the federal government. Ontario's Agreement was signed on April 24, 1962. Quebec, on the other hand, has administered its own provincial personal income tax since 1954.

The terms and provisions of the Tax Collection Agreements[1] confer upon the federal government a considerable degree of regulatory authority that ensures provincial conformity with federal statutes, regulations and interpretations. Provincial autonomy, vis-a-vis tax policy, is thereby reduced. In Part III of this paper, the limitations for Ontario, in relation to the flexibility of response in integrating the personal income tax and transfer payment systems, will be explored.

1. For a detailed analysis of the Agreement, refer to the essay entitled **The Federal-Provincial Tax Collection Agreement: How Ontario Receives its Personal Income Tax**.

The Social Program Field

Principles

The modern development of most Western economies has been influenced strongly by the principles espoused in Adam Smith's **An Enquiry into the Nature and Causes of the Wealth of Nations**, first published in 1776.

The uneven economic cycles, characterized by periods of great economic growth followed by periods of recession or depression, were climaxed by the arrival of the Great Depression in 1929. The serious economic and social consequences experienced were interpreted as indications that the ravages of unbridled capitalism could not be allowed to continue unchecked. Clearly, a system of counter-balancing measures was needed.

In 1936, John Maynard Keynes' **The General Theory of Employment, Interest and Money** introduced a new notion of the government's role in ensuring economic and social stability. Keynes argued that, during periods of economic declines, governments should infuse large amounts of public funds, through deficit financing, into the economy to protect the social well-being of its citizenry and as an economic stimulus for growth.

During periods of strong economic growth, governments could repay their borrowings by exacting the required monies from the new wealth created in the economy. Keynes' theory was adopted with enthusiasm in both Canada and the United States.

In 1942, a Royal Commission, chaired by Lord Beveridge, the **Social Insurance and Allied Services (the Beveridge Report)**, tabled its findings. The contents of the report, which included proposals for equality of opportunity, universality of program coverage and objectives of income redistribution, became a "Magna Carta" of social security in Anglo-Saxon countries.

The writings of Keynes and Beveridge have had a profound effect on Canadian social policy, an effect which has made an indelible impression on the Canadian definition and view of social justice. Since the dates of publication of these works, the Canadian goal has been to expand program coverage, add individuals and groups, and improve benefit and protection thresholds.

Programs and Administration

Federally, the government introduced unemployment insurance in 1940, followed by family allowances in 1945. In 1952, old age pensions were introduced, and, in 1966, the Guaranteed Income Supplement (GIS) was established for the needy elderly. Also, in 1966, the Canada Pension Plan (CPP) was introduced.

In concert with the provinces, the Canada Assistance Plan established cost sharing of provincial and municipal welfare programs. In the 1950's and 1960's, federal equalization payments were introduced to ensure that governments of poorer provinces were afforded the same income-per-

capita ratio as richer provinces.

At the same time, provinces and municipalities have established social program systems, based on their own specific social program policy priorities. At the Ontario provincial level, the principal programs of social assistance are administered via Family Benefits and General Welfare Assistance legislation.

The rapid development and variety of social programs introduced by three levels of government have not been effectively co-ordinated. While improvements have been made, there still exists a good deal of overlap. In some cases, the same recipient receives financial support from more than one level of government for the same social purpose.

The eligibility criteria, amount of social assistance (or tax or transfer assistance), frequency of payment and length of eligibility may vary among three support mechanisms. There is also a significant administrative cost for the delivery of such a splintered social assistance delivery network. There are problems of information exchange and sharing between and among program administrators, not just between government levels but also within government levels.

In some cases, such exchange is impeded by federal and provincial protection of personal privacy legislation. With regard to exchange of information between the tax and transfer systems, confidentiality provisions of federal and provincial tax statutes specifically forbid the use of personal data for non-tax purposes.

The absence of information exchange is a serious problem in the development of a well co-ordinated, and administratively efficient, transfer payment system. Until such co-ordination problems are addressed, prospects for a more rationalized tax and transfer system would seem to be unlikely.

As a final comment, it is not at all clear that any level of government would desire a more rationalized tax and individual transfer payment system. To achieve such an objective, one (or more) level of government may lose visibility with the taxpayer as the result of a single administrative network. To do so may cause a public perception that the level of government losing visibility has vacated this field of social policy, a public perception that governments, at any level, would most surely wish to avoid.

Tax Principles and Social Policy

By reviewing the contents of Appendix A, it is apparent that adherence to the principles of taxation can sometimes result in conflict among various principles and with the objectives of social and economic policy. Three examples are used as illustrations of the latter conflict.

Most Western societies tax alcohol and tobacco at a much higher rate than other consumer goods. While this is a clear violation of the principle of neutrality, it is generally accepted that alcohol and tobacco are luxury goods whose consumption should be controlled within certain

limits. The use of "sin" taxes on these goods is, in part, rationalized as a means of curbing their consumption. Here, the priority of social policy overrides strict observance of the principle of neutrality.

Many Western societies also provide an exemption from real property taxation to churches and registered charitable organizations. Again, such an exemption violates the principles of neutrality, horizontal equity and benefits received. From a social policy standpoint, exemption from real property taxation is deemed justified on the basis of the valuable social contribution made by these organizations.

In recent decades, federal and provincial tax policies have often provided tax concessions based on the location of the taxpayer. Such preferential treatment is used as an inducement for certain taxpayers to locate in areas, generally regarded as economically disadvantaged, where the taxpayers would not otherwise locate. While this inducement may be in support of social or economic policy in the provincial or national interest, it is in clear violation of the principle of horizontal equity. Other taxpayers, in equal circumstances, who do not locate in the designated location, are treated differently by the tax system.

These illustrations of conflict between the principles of taxation and the objectives of social and economic policy are not meant to suggest that the will of the people should be stifled because a taxation principle would be violated. At the same time, when such situations occur, or during the process of social policy development, attention should be given to the predictable consequences of such action. In this way, recognition, and acceptance, of effects will be known in advance, rather than becoming apparent only after implementation.

PART II

RATIONALIZING THE TAX AND TRANSFER SYSTEMS: THE QUEBEC EXPERIENCE

Quebec's Historical Backdrop

In contrast with developments elsewhere in Canada, Quebec remained in not-so-splendid isolation, with health and education standards amongst the lowest in the developed world. Most health and social services were controlled by religious organizations, which were not subscribers to the philosophy of non-denominational universal access. At the same time, thoughts of government intervention were also a philosophic anathema to Quebec society.

It was not until the Quiet Revolution of the 1960's that Quebec entered the enlightened age of the general framework of social security. During the 1960's and 1970's, investment by Quebec governments in public services outpaced most North American jurisdictions. The pace of Quebec government intervention in the economy was also more rapid than elsewhere, primarily through the creation of crown corporations for economic development.

Another driving imperative for Quebec was its need for uniquely provincial responses - ***Quebeçois responses*** - designed to meet its political, economic and social challenges. Within this imperative, was the traditional Quebec fervour to maintain the truly distinctive characteristics of its cultural and social fabric. The Quebeçois identity would never be the same as the rest of Canada. The fundamental philosophy of Quebec public spending is based on the assumption that the francophone population must be protected, and that only the government of Quebec can do so adequately.

Since the beginning of the 1960's, Quebec, like other provinces, acquired most of its public spending resources through transfers from the federal government. From 1960-66, the federal government transferred taxation points to the provinces. From 1966-70, Quebec sought exclusive access to income, profits and succession duty bases. During the 1970's, Quebec sought to recover the entire social security field, with its growing sovereignty demands oriented toward recovery of all tax sources.

Financial Effects of Quebec's Social Policy Programs

In 1969, Quebec's myriad of social programs were subsumed into the Social Aid Act, which revised all social assistance plans and consolidated them into a single program based on the following principle:

> **There shall be the same poverty threshold for every person or household, regardless of cause of need, whether able to work or not.**

Within a few years after the introduction of the Social Aid Act, it became apparent that the system's general level of financial support, as determined by the state, became a disincentive to work, especially for large families, whose level of assistance was well above the minimum wage. The minimum wage, paid to an individual employee, did not bear any relation to size of the employee's household, nor to the employee's family financial needs.

Significant increases in the minimum wage, beginning in the early 1970's, resulted in Quebec having the highest minimum wage in North America by June 1975. While this protected individual income levels, it also produced a higher labour production cost for Quebec-based employers.

The need to secure revenues to support the rapidly increasing expenditure demands of the social program network contributed to Quebec's individual tax burden being 20% higher than Ontario's by 1977. There was general, and vociferous, concern amongst taxpayers that tax burdens were unfairly high.

The best summary overview of the situation is described by the **White Paper** (p.11):

> **The body of protection measures implemented by successive governments in Quebec has very nearly produced, in all groups of society, a kind of disincentive to work, to the accumulation of wealth and to progress.**
>
> **Under a flood of subsidies, local authorities have a much greater incentive to obtain as much government money as possible rather than respond to the true needs of their citizens. Over-taxed businesses end up being convinced that any improvement in their performance is just another encouragement to government to appropriate most of the proceeds of that performance to finance its own apparatus. The disincentive to work is universal among individuals. At the bottom of the income scale, the protection they receive is so good that returning to work would place them in a situation where they lost to the government most of the income they earned. Midway up the scale, the magnitude of income tax discourages effort, while, at the top, marginal rates which are unequalled in Canada generate continual protest and pressure...**

Inconsistencies Between Quebec's Personal Income Tax and Transfer Systems

There were many inconsistencies in the definition and treatment of similar terms and circumstances between the tax and transfer systems. These inconsistencies stem, in part, from differing original purposes of the two systems. As can be seen from the text which follows, any rationalization of the two systems is very much dependent on establishing a far greater degree of conformity of definition and treatment of like situations.

The Taxpaying Unit

The taxpaying unit, whether a single person, childless couple or couple with children, is the basic economic unit in the personal income tax system. The tax system does not recognize a *de facto* spouse, who may be a dependent of the taxpayer. Only a spouse of a legally married taxpayer may be recognized as a spouse, dependent or otherwise, even though the essential needs of the family unit may be exactly the same, a fact recognized by the social program transfer system.

Since each taxpayer is taxed as a taxpaying unit, married spouses, both of whom are employed outside the home, are subject to a lower tax burden as a couple than is a married couple, only one of whom works, but who earns as much as the two employed spouses combined. This results from each employed spouse having individual access to personal exemptions and a lower rate of marginal tax (on the tax progressivity scale) on a lower level of personal income. The single-income-earning couple, by comparison, has a personal exemption for the taxpayer and a dependent spouse exemption, the latter being lower than the individual taxpayer personal exemption. In addition, the tax progressivity scale results in a high marginal tax rate for the single-income earning couple.

At the same time, making the taxpaying unit the household, as does the transfer payment system, could discourage a non-working spouse from entering the labour market, since the income of the second spouse would be effectively taxed at the top marginal tax rate of the combined income. Taxing household income may become a disincentive to marry.

In addition to the use of the equivalent-to-married exemption available to single-parent families, an extra exemption for senior citizens, based on age alone, also is contrary to neutrality and equity principles. Other taxpayers, with equal incomes, but of a younger age, are not treated equally by the tax system.

Deductions for Student Expenses

At the time of the study, neither the federal nor the Quebec tax system made adequate allowances for the expenses actually incurred by students. Deductions were restricted to tuition fees. At the same time, the deduction was not transferable to the parent, even if the student had

no income and the parent had paid the tuition fees, while the eligibility of the student for a student loan and/or grant took into consideration the income of the parents when calculating the student's financial situation. Neither could the deduction be carried forward by the student to a tax year when it could be used to offset income received.

Such inconsistencies did not exist within the transfer payment system. While living in the household, the student was considered an ongoing member of the family and financial support was provided accordingly.

Employment Expense Deductions

With respect to expenses incurred to earn income, self-employed taxpayers and employee taxpayers were treated in an inequitable manner by the tax system. For self-employed persons, all related expenses incurred to earn income were deductible from income for tax purposes.

For individual employees, the federal government provided an annual deduction of 3% from gross income to a maximum of $500 (this has been eliminated as part of federal tax reform policy). For many employees, and for those receiving social assistance, the costs of being employed were considerably higher than the allowable deduction. The net effect for some persons receiving social assistance was a reduction in disposable income upon entering the labour market, a factor which became a real disincentive to work.

Child Care Expenses

There was great disparity between the tax and transfer systems in the treatment of child care expenses. At the time of the study, the Quebec tax system provided child care deductions for children under age 14 years on the lesser amount of $2,000 per child to a maximum of $6,000 per family, or two-thirds of the taxpayer's earned income, whichever was less.

Families with children under age six years could choose between the child expense deduction or Quebec's family allowance payment (known as the availability allowance), whichever was more advantageous for the taxpayer. The availability allowance was set at $300 for the first child under age six years, $200 for the second and $100 for the third and subsequent children under age six years.

The study found that neither the child care deduction nor the availability allowance bore any relationship to the actual cost of child care, particularly for younger children. For pre-schoolers, the actual cost of child care, even in some subsidized centres, far exceeded the maximum allowable deduction, while the maximum allowable deduction for school-age children was often overly generous in relation to essential needs.

Finally, only the supporting taxpayer with the **lowest** income could claim the deduction. The study questioned why the supporting taxpayer with the **highest** income was prevented from claiming the deduction.

The overall result was that the tax system contained strong disincentives for a second spouse, or a single parent, from entering the labour market. Allowable expense deductions did not recognize the true costs associated with earning an income.

Dependent Children

The allowable exemption for dependent children in the Quebec tax system varied according to the ages of the children - those under age 16 years, those aged 16 and 17 years, and those aged 18 years and older.

Instead of granting an exemption of $710 for dependent children under age 16, and taxing the federal family allowance (the approach used by the federal government), Quebec paid a separate provincial family allowance, taxable neither by the federal nor Quebec tax systems. For children aged 16 and 17 years, Quebec provided a dependent child deduction of $770 in addition to its provincial family allowance benefit. However, the Quebec family allowance payment became taxable in the federal tax system.

For dependent children aged 18 to 20 years, or aged 21 years or older but still in school or disabled, an exemption of $1,260 was granted. However, there was eligibility for neither the federal nor provincial family allowance payment.

The Quebec family allowance payment, unlike its federal counterpart, was graduated according to the number of children in the family. This approach was intended to reduce the level of social aid benefits to large families to a level not exceeding the minimum wage. In this way, the head of the family would not be induced to remain dependent on social assistance rather than enter the labour market.

However, the level of essential needs of the first three dependent children recognized by the tax system was lower than the comparable level of social aid by as much as 50%.

Indexation

The objective of indexation in the tax system is to ensure that the nominal value of tax payments increases at the same rate as inflation, independent of any changes in the taxpayer's purchasing power, thus maintaining the relative progressivity scale of the tax tables. Expressed another way, indexation ensures that an increase in the taxpayer's income is discounted by the rate of inflation, since that level of income increase is necessary to maintain the relative amount of disposable income and purchasing power. Only real increases in income, (i.e. income increases above the inflation rate), should be subject to income taxation.

The federal government introduced indexation into its personal income tax system in 1974. The level of indexation was lower than the annual rise in the Consumer Price Index (CPI). Quebec followed suit in 1978, but indexation applied only to personal exemptions and was not related at all to the annual rise in the CPI. The level of indexation was established each year at the time of the Quebec Budget Speech.

This approach was of particular benefit to low- and middle-income taxpayers who received low increases in income but were partially protected by indexed personal exemptions. Conversely, the lack of indexation of income meant that taxpayers who received income from interest on savings or from investments were taxed on the full amount of income, with no discount for inflation. During periods of high inflation, investors faced the prospect of paying higher taxes with no real (after accounting for inflation) increase in investment income or purchasing power.

As a means of providing some measure of taxpayer protection, both the federal and Quebec governments exempted the first $1,000 of interest and/or investment income from taxation (this also was eliminated by the federal government under its tax reform plan). However, taxpayers who received substantial proportions of their annual income from these sources found themselves very much disadvantaged relative to other taxpayers.

In the social program arena, benefit levels were generally raised in proportion to the rise in the CPI. Occasionally, benefit levels were increased at a rate higher than the rise in the CPI. Over time, the relative disparity between the treatment accorded taxpayers and transfer payment recipients widened, thereby destabilizing an already tenuous degree of equilibrium between the tax and transfer systems for the protection of essential needs.

Administrative Differences

The Quebec tax system consists of a single administrative mechanism. In contrast to Ontario, Quebec also enjoys the additional advantage of having policy and administrative control over its provincial personal income tax system. A solitary administrative system has obvious benefits for better co-ordination, control, effectiveness and efficiency.

By comparison, the social program system was a splintered administrative network. At the time of the study, there was a variety of federal and provincial programs which provided transfers to individuals. The programs could be divided into three general categories:

1. a guaranteed basic minimum income (11 Quebec programs and five federal programs);

2. employment income maintenance (six Quebec programs and two federal programs);

3. assistance for entering the labour market (two Quebec programs).

The overlapping effect of federal and provincial programs at times resulted in multiple benefits for the same social need. Sometimes the benefits were intended as supplementary. On other occasions, the benefits provided duplicate income support for the same need. In such cases, the essential needs treatment of a similar circumstance within the personal income tax system meant that a taxpayer received a lesser degree of tax relief than a social program beneficiary received as direct income support.

The Overall Effects

By 1983, there was general taxpayer discontent in Quebec society. Taxpayers, particularly middle- and upper-income taxpayers, felt that their tax burden was excessive. In comparison with those in other Canadian and American jurisdictions, these feelings were understandable.

Persons, particularly those who were heads of larger families, whose income was derived from social aid benefits, felt that the income-reduction consequences of entering the labour market, either at the minimum wage level or the average industrial wage level, relegated them to a life of perpetual state assistance. The results of the White Paper study revealed that these feelings were also justified.

Employers, who were faced with the simultaneous features of higher business taxes than experienced elsewhere in Canada and one of the highest minimum wages in North America, felt little incentive to improve performance to achieve higher profitability. Higher profits would only be confiscated by an oppressive tax system. They, too, had reason to feel disadvantaged.

On the receiving end of all this dissatisfaction was the Quebec government, at which all societal factions had firmly fixed their gazes in search for a resolution to their problems.

PART III

CHOICES FOR QUEBEC

Introduction

Faced with the quandary of finding solutions for apparently mutually-exclusive interests, Quebec developed three options for reform, and for public debate. The options, though different, were not mutually exclusive. There were strong commonalities in orientation and principles associated with all three options. The differences related to the conditions associated with eligibility for social assistance, zero-tax threshold levels (the level below which no provincial personal income tax is payable), tax incidence, and, in the case of Option III, the consumption tax base. The essential components of each option are outlined below.

Option I

This option closely paralleled the state of the social assistance system at the time of the study. Both short- and long-terms needs of the recipient were covered, and social assistance was provided whether or not recipients were prepared to participate in activities designed to facilitate their re-integration into the labour force.

To provide an incentive to work, Option I proposed to increase the zero-tax threshold level, particularly for families with children. This approach would ensure that the combined rate of reduction in social aid benefits and the rate of income tax applied to income earned would not result in a reduction of the taxpayer's ability to provide for essential needs. For a social aid recipient who accepted a job at the minimum wage, the combined reduction in social aid benefits and the marginal tax rate would be equivalent to the wage earner retaining only 33% of earned income.

Option I also proposed to reduce the number of taxable income brackets and the progressivity of the tax table. The marginal tax rate would be reduced from 32% to 30%.

Option II

The principal difference in this option was the requirement of a person capable of working being obligated to participate in work force re-integration activities, or work part-time, to protect the social aid coverage of both short- and long-term benefits. Persons refusing to satisfy this requirement would have their long-term benefits reduced, while those who did satisfy this requirement would receive an additional clothing allowance beyond their short- and long-term essential needs.

As a further incentive to work, a social aid recipient re-entering the labour force at the minimum wage level, would retain about 50% of earned income, rather than the 33% retained under Option I. By being able to retain a higher percentage of earned income, social aid recipients would be encouraged to seek employment.

While Option II proposed no other changes to the number of taxable income brackets or progressivity of the tax table, it did include a slight increase in the zero-tax threshold level contained in Option I.

Option III

This option contained major changes in consumption taxes as a means of generating additional tax revenues in support of objectives of incentives to work and economic efficiency. By applying a sales tax to all consumption goods, except for food, prescription drugs and professional services, an estimated $900 million in additional tax revenue could be raised.

This tax revenue could be used to reduce tax rates for all taxpayers, with marginal rates ranging from 13% to 28%, compared with 16% to 30% under Options I and II. While all taxpayers would enjoy lower tax rates, the greatest reductions would be for middle- and high-income taxpayers. The zero-tax threshold level would also be increased above the levels proposed in Options I and II.

Option III proposed similar provisions to Option II relating to social aid recipient eligibility for short- and long-term essential needs, and maintained the retained earnings rate at 50% for social aid recipients entering the labour force at the minimum wage.

Common Reform Elements

The options outlined above contain the major components of the structural changes proposed. In concert with these changes, were a number of other reform considerations, some of which were common to all options, and some of which were unique to a given option. Summarized below are those that were common to all options.

Concerning the Tax System

The White Paper proposed a more rationalized approach to the system of personal exemptions and deductions to ensure that, for every household type, the income necessary to provide essential needs would not be taxed. To achieve this objective, within Quebec's provincial tax system, the study recommended that:

- the basic personal exemption be adjusted to correspond to the level of recognized essential needs;
- the basic personal exemption and married person exemption be made equal, thereby harmonizing the exemptions granted to couples in which both spouses work with those granted to couples with only one spouse in the labour force;
- the married person exemption be extended to *de facto* spouses;
- a new exemption be granted to compensate single persons living alone in a separate dwelling for their additional essential needs;

- the dependent children exemptions be modified to reflect more adequately the essential needs of such children,
  - by introducing a new system of exemptions for dependent children under age 16 years;
  - by maintaining family allowances for families who so desire;
  - by retaining the availability allowance only for children under age two years;
  - by increasing the exemption for dependent children over age 21 years;
  - through the introduction of a new exemption for the first child of a single-parent family to replace the equivalent-to-married exemption; and
  - by abolishing the exemption for amounts of income earned by a dependent child, thereby reducing the amount of personal exemption for the child by every dollar earned by the child.

- the marginal tax rates for all taxpayers be reduced to make Quebec more competitive with other jurisdictions;

- the standard deduction for employee-related expenses be increased from 3% to 6%, with the maximum deduction rising from $500 to $750;

- child care expense deductibility be modified, to take fuller account of expenses actually incurred, by
  - increasing the maximum deduction for children under age six years from $2,000 to $3,120 (1983 $);
  - setting the maximum deduction for children aged six to 11 years at $1,560;
  - allowing the spouse with the higher income to claim the deduction; and
  - abolishing the deduction for children aged 12 and 13 years.

- a new system of property and sales tax credits be introduced to compensate low-income taxpayers for taxes paid on expenditures to cover essential needs;

- a dependent student's deduction for tuition fees be transferable to the parent(s), with the student having the option to carry the deduction forward to future years; and

- to ensure improved taxpayer equity, the following measures be abolished:
  - exemption of the first $500 of income from grants and scholarships;
  - the general charitable and medical expense deduction of $100; and
  - the $2,100 age exemption for older persons still employed.

Concerning the Transfer System

The study proposed a number of recommendations designed to develop a more rationalized social assistance system. In addition, there was an identified need to ensure compatibility of the transfer payment and tax systems. The study proposed that:

- for persons able to work, that a single income guarantee system be created, which would consolidate the various support programs of social aid, employment income supplement, child care assistance, family allowances, availability allowances, and property and sales tax credits;

- low-income workers be entitled to retain a higher portion of social assistance benefits while employed, and that they be relieved of all income tax liability as long as they remained eligible to receive social assistance;

- supplementary social assistance benefits be paid to those able to work, who participate in activities designed to enhance their re-integration into the labour force (i.e industrial training, further education, community work, etc.);

- benefits under the income guarantee program be tied to amounts spent by low-income households to satisfy essential needs, with child care assistance added to these benefit amounts, where necessary;

- the existing social aid program be maintained for those unable to work;

- the student assistance program be harmonized with the new income guarantee program by taking the income of the parent into account when calculating the benefits to be paid under the income guarantee program to beneficiaries aged 18 to 20 years;

- a child care expense subsidy be added to the essential needs of the guaranteed income program;

- the maximum child care expense subsidy be equal to the maximum child care expense deduction allowed by the income tax system; and

- the child care expense subsidy be made available both to those who participate in programs designed to enhance re-integration into the labour force and to low-income workers.

Concerning the Integration of the Tax and Transfer Systems

As discussed previously, the inconsistencies of taxpayer/recipient treatment by the two systems needed to be addressed. From perspectives of neutrality and equity, certain changes were required. The study recommended that:

- a lump-sum tax reduction be introduced, raising the zero-tax threshold level and preventing the simultaneous application of the tax and transfer systems - a taxpayer would not pay income tax while receiving income guarantee benefits;

- a common indexation mechanism be applied to the tax and transfer systems - transfers and personal exemptions would be indexed at uniform rates; and

- the tax and transfer systems adopt compatible definitions of income, assets, needs to be considered, declaration unit and accounting period.

The Recommended Option

Given the differences, from Option I, which as a "stand pat" proposal did little to resolve the problems which gave rise to the study, to Option III, which required a major tax policy change to expand the consumption tax base, it is not surprising that the study recommended Option II.

Option II redressed the tax burden of families with children and of middle-income taxpayers, and improved the relative competitiveness of Quebec's tax system in relation to neighbouring jurisdictions for high-income taxpayers.

By allowing low-income earners to retain a higher proportion of employment income, their incentive to work would be increased, while differential benefit amounts would induce social assistance recipients to re-enter the labour force as well.

Events Since the White Paper Report

The White Paper was officially released in the fourth quarter of 1984. Even before the conclusion of public and parliamentary committee consultations, certain components of the White Paper were introduced in the 1985-86 Quebec Budget announced on April 23, 1985.

A review of Quebec provincial budgets beginning in fiscal year 1985-86 and including fiscal year 1991-92 is contained in Appendix B. It is clear from a perusal of the contents of Appendix B that Quebec has maintained a steadfast allegiance to the White Paper's recommendations.

With the accord signed in 1990 between the governments of Quebec and Canada for a harmonized Quebec provincial sales tax and federal Goods and Services Tax (GST) system to be administered by the province of Quebec, it appears that the expanded sales tax base proposed

in Option III of the White Paper will also be accomplished.

At the time of the study, the White Paper authors, while outlining the benefits of an expanded consumption tax base, felt that this consideration may have been unacceptable to Quebec society at the time. A main objection to those who view sales taxes as a regressive form of taxation has been addressed by the Quebec tax system. In addition to the refundable GST credits provided by the federal government, the Quebec government has also developed its own provincial refundable sales tax credit. The provincial credit, geared to low-income households, is designed to mitigate the sales tax effects on income necessary to provide essential needs.

The Extent of Tax and Transfer Systems Rationalization - 1991

Today, Quebec still does not have a fully-integrated tax and transfer system. Although there is potential for its creation, the personal income tax system is not used to distribute the benefits of the various social assistance programs (i.e. a "negative" income tax). Even so, there is a far greater degree of integration, co-ordination and information exchange between the tax and transfer systems in Quebec than is the case in Ontario.

Quebec's personal income tax system contains a family tax reduction component (Ontario has its own Ontario Tax Reduction program), and property and sales tax rebate programs (Ontario has the Ontario Tax Credit and Ontario Tax Grant programs). In addition, a reconciliation of benefits paid to recipients of Quebec's **APPORT** program, which provides social assistance benefits to persons returning to the labour market, is conducted annually with income data recorded in the personal income tax system. This ensures that the eligibility for **APPORT** benefits, and the income received therefrom, remains within established program criteria.

In comparison, while Quebec administers its own provincial personal income tax system, Ontario's is administered on its behalf by the federal government. While Quebec has the authority to reconcile **APPORT** program data with provincial personal income tax data, Ontario may not do so with its Supports to Employment Program (**STEP**), which also provides social assistance to persons returning to the labour market. The cross-referencing of individual **STEP** data with taxpayer information contained in personal income tax files would violate the provisions ascribed to taxpayer data collection and use contained in the Exchange of Information Agreement with Revenue Canada, Taxation.

PART IV

CHALLENGES FOR ONTARIO

Restrictions of the Tax Collection Agreement (TCA)

Provinces accept four basic limitations on provincial authority and flexibility. They are:

1. Provinces are prevented from introducing any tax credit scheme, without the approval of the federal government, which would induce investment income or preference which discriminates with respect to the jurisdiction location of the investment. For example, Ontario could not use the personal income tax system to encourage investment in Ontario-based companies to the exclusion of companies in other provinces.[1]

2. Provincial tax legislation must accept the same tax base as defined under the federal Income Tax Act. Provincial personal income tax is based on a single rate percentage of "basic federal tax", the calculation of which is determined entirely by federal definitions of amounts and types of income and amounts and types of allowable deductions. Similarly, the amount and definitions of federal non-refundable tax credits must be accepted by the provinces.

3. Provinces agree that provincial legislation and regulations will be kept in a form similar to the federal Act and regulations.

4. The provinces covenant that they will not impose a tax on:

    - employees of another country, members of the family and servants of employees of another country;

    - municipal authorities, municipal or provincial corporations, or registered charities;

    - non-resident-owned investment corporations; or

    - corporations issuing qualified shares, deferred profit sharing plans or certain property acquired in trust governed by deferred income plans, which may give rise to a refundable tax.

1. The Ontario government has announced its intention to establish the Ontario Ownership and Worker Investment Plan, a program which provides federal and provincial tax credits for employee investment in their Ontario-based companies. Similar plans have been introduced in other provinces under the federal criteria of the Labour Sponsored Venture Capital Corporation program.

The TCA also requires that provinces determine their provincial income tax rates as a percentage of "basic federal tax"[1]. This "tax on tax" approach limits provincial flexibility in the setting of tax policy. For example, the federal government has complete authority over the definition of income, as well as the definition and amounts of personal deductions, exemptions and non-refundable tax credits.

These limitations prevent the provinces from adjusting taxable income as a means of establishing a distinct provincial definition of income, or using the personal income tax system as a means of re-distributing income in concert with unique provincial social or economic policies. Provinces are restricted from:

- adding back income or treating certain types of income separately, such as real estate gains;
- using the PIT system as a means of introducing a wealth tax;
- income-testing certain provincial grant or social benefit payments;
- taxing 100% of capital gains;
- limiting or expanding certain deductions from income; or
- introducing lower tax rates for specific groups of taxpayers or particular types of income, such as small business.

Since the federal government is granted dominion over these areas under the terms of the TCA, provinces are barred from using the most progressive system of taxation as a vehicle to implement instruments of social and economic policy.

As a means of illustration, relative to the degree of policy freedom enjoyed by the province of Quebec, all italicized elements of the Quebec provincial budget changes contained in Appendix B would be expressly forbidden to provinces which are partners to the TCA.

1. In the federal government's 1991 Budget tabled on February 26, 1991, the Finance Minister announced the federal government's intention to commence discussions with the provinces for changes to the Federal-Provincial Tax Collection Agreement. Topics for discussion, designed to respond to provincial demands for greater flexibility, include allowing provinces to apply their provincial tax rates against taxable income, rather than against basic federal tax. The federal discussion paper was released on June 25, 1991. A four-member advisory committee, chaired by Robert Brown, Chairman of Price Waterhouse of Toronto, has been commissioned to review technical aspects of the paper, conduct public consultations, and report back to the federal Finance Minister by October 1, 1991.

Provincial Tax Credit Mechanisms

While to a great extent restricted, the provinces have had some success in negotiating selected provincial tax policy initiatives within the terms of the TCA. In Ontario, the Ontario Tax Credit program, comprised of property and sales tax credits and the Ontario Home Ownership Savings Plan tax credit, provide specific tax relief from provincial income tax for eligible low- and middle-income taxpayers. Under the Ontario Tax Credit program, a provincial political contribution tax credit is also provided, although, unlike other Ontario Tax Credit programs, it is not income-related.

In addition, Ontario has introduced the Ontario Tax Reduction program to remove additional low- and middle-income taxpayers and their dependents from the provincial income tax rolls.

Lastly, as a response to reduced progressivity of the tax table resulting from federal tax reform, Ontario levies a surtax on Ontario personal income tax over $10,000. For the 1990 taxation year, the surtax was 10%. For the 1991 taxation year the surtax is 12%, and for the 1992 taxation year the surtax will be 14%.

Provinces must seek federal permission to introduce provincial tax credit schemes. The federal government has full authority to deny provincial requests, as it did to Ontario's request to introduce a flat-tax component in the calculation of Ontario provincial tax. Approval was withheld, even though two western provinces had previously been granted permission to introduce flat taxes.

Negotiations for a Revised Tax Collection Agreement

In the 1991 federal Budget, tabled on February 26, 1991, the federal finance minister announced his intention to consider changes to the TCA in response to provincial requests for greater flexibility.

Most notably, the western provinces had developed an alternative model, and publicly declared their intention to withdraw from the TCA unless provincial concerns were addressed. A federal discussion paper, dated June 25, 1991, uses an "illustrative" model based to a large extent on the proposal of the western provinces, as a basis for comparison with the present TCA.

The federal paper begins a formal process for public consultation and debate on the future terms and provisions of the TCA, and, indeed, on the future of the TCA itself.[1]

1. For a review of the federal discussion paper, refer to the essay entitled **Personal Income Tax Coordination - The Federal-Provincial Tax Collections Agreements: An Analysis of the Finance Canada Discussion Paper.**

Ontario's Social Assistance System

Historically, Ontario's social assistance system has been comprised of two basic programs - the Family Benefits Act of 1967, administered by the province, and the General Welfare Assistance Act of 1958, administered by municipalities and Indian bands.

In July 1986, the Ontario government commissioned a review of the provincial social assistance system and requested recommendations for change. The Social Assistance Review Committee (SARC), which undertook the review, tabled its report, **Transitions**, on September 1, 1988.

The SARC Review

The SARC review was centred on four basic questions. They were:

1. What should be the guiding principles and objectives of social assistance and related programs?

2. To what extent is the present system meeting these objectives?

3. What overall strategies for change should the province adopt?

4. What parameters should the province adopt as it moves to change its legislation?

<u>Objective of the Social Assistance System</u>

The guiding objective that SARC determined as the basic approach to social assistance was that:

> **All people in Ontario are entitled to an equal assurance of life opportunities in a society that is based on fairness, shared responsibility, and personal dignity for all. The objectives for social assistance, therefore, must be to ensure that individuals are able to make the transition from dependence to autonomy, and from exclusion on the margin of society to integration within the mainstream of community life.**

This objective was embraced by the government in office at the time of the report and has been reinforced by the current government. Presently, social policy uses this basic objective as its guiding theme in the construct of social policy initiatives and instruments.

Taxation

Similar to the inconsistencies cited in the Quebec White Paper, which is referenced in the **Transitions** report, Ontario recipients of social assistance are disadvantaged by the tax system when they return to the labour force in low-paying jobs. The high implicit marginal tax rate for income earned in excess of an equal income level provided through social assistance was identified as a significant disincentive to work.

The **Transitions** report also expressed concern regarding the federal tax reform movement aimed at deriving a higher proportion of tax revenues from consumption taxes. Consumption taxes are generally considered regressive, since they apply equally to all consumers without due application of the principle of ability to pay. Significantly enhanced refundable sales tax credits are required to offset the regressive effects for low-income persons.

Still, SARC was committed to using the personal income tax system as the principle source of tax revenue because of its progressivity features. Tax progressivity reflects the value basis of the SARC report - emphasis on equal sacrifice, social solidarity, shared responsibility and interdependence.

Inconsistencies Between the Tax and Transfer Systems

As was the case with Quebec, the administrative mechanism of Ontario's transfer system is far more splintered than is the tax system. As well, the definition of similar terms, and the income benefits provided via the transfer system, are not compatible with the level of tax-free income necessary to provide for essential needs within the tax system. To be fair to taxpayers, income related to essential needs should be shielded from taxation.

Unlike Quebec, however, Ontario's partnership within the TCA specifically prevents Ontario from resolving some of these disparities, unless Ontario chooses to abide by the federal definitions.

Even within provincial Budgets, the **Transitions** report (p. 97) cited an example of the inherent incongruity between the tax and transfer systems.

> **Unfortunately, the interrelationship between the tax and transfer systems, and the potential harm it can do to the poor, is still not well understood, as evidenced by the 1988 Ontario budget. This budget did contain some measures of direct benefit to social assistance recipients. For example, an additional $20 was provided to help recipients cover utility costs. An estimated 23,000 recipients were expected to benefit from this measure by an average of $50 per month.**
>
> **Social assistance recipients were also affected by some of the tax measures announced in the budget, however, most notably the increase in the sales tax**

from 7% to 8%. And, although there were nominal increases in Ontario tax credits, changes in the financial tests used to determine eligibility actually reduced the value of the tax credits for some recipients. When the increase in benefits and the tax changes were considered together, we estimated that 60,000 social assistance recipients would be worse off financially as a result of the budget than they would otherwise have been. The losses, as high as $108 per year, were expected to affect primarily single parents and people with disabilities.[1]

As a result of these findings, SARC recommended that no change to transfer payment programs be considered without assessing the implications for the tax system, and vice versa. SARC also recommended that such cross-referencing be an automatic feature of policy development within the taxation and income security fields within the Ontario government.

While a closer co-ordination of tax and transfer program systems was recommended, in none of its 274 recommendations did the **Transitions** report suggest an integrated tax and transfer payment system.

Guaranteed Annual Income

The SARC review also explored considerations of a guaranteed annual income (GAI) system. This notion is generally based on conceptual features centring around:

- o a universal guarantee of a minimum level of income for every man, woman and child;
- o a presumption that most people would and could receive most of their income from employment;
- o a presumption that it would be a national program, delivered by the federal government by means of a negative income tax;
- o a rationalization of virtually all existing income security programs, including provincial social assistance; and
- o an income test to the benefit to ensure that only those below a certain level of income would be eligible.

1. Ontario Budgets after 1988 have introduced further initiatives to help reduce the tax burden on single parents and low to medium income taxpayers. Enhancements to the restructured Ontario Tax Reduction program have been specifically targeted to these groups.

The **Transitions** report asserted that the objective of GAI should be the focus of income security reform, although the report did not propose a GAI because of concern that the features outlined above may not be achieved by a "pure full-blown" GAI. A GAI focus could be seen to be shifting emphasis toward social support and away from encouraging self-reliance through generating jobs. The GAI approach was also considered by SARC to be a passive, rather than an active, approach. Finally, the conformity of the GAI concept was seen as having limitations in responding to unique individual needs when such a response was warranted.

Ontario currently has a GAI for eligible senior citizens only. Administered by the Ministry of Revenue, the Guaranteed Annual Income System (GAINS) provides a guarantee of income above the minimum guaranteed by the combined benefits provided by the federal Old Age Security (OAS) and Guaranteed Income Supplement (GIS) programs.

Prospects for Ontario

In view of the considerations previously addressed, Ontario has limited flexibility at present. Before any decisions can be reached, answers are required to some very fundamental questions.

The Personal Income Tax System

To determine what degree of co-ordination or integration between the tax and transfer systems is desirable, a strategic policy question must be addressed. For what purpose(s) is the personal income tax (PIT) system to be used in future?

At present, Ontario's PIT system is used principally as a revenue generation device, with some modest income redistribution features and low income relief provisions. Is the PIT system to serve a future role in a more specific way to deliver social programs and economic incentives to meet Ontario's social and economic policy agenda?

Is Ontario considering some form of provincial guaranteed annual income, for which the PIT system would be used as a vehicle for implementation? Until these basic questions are answered, there can be no resolution of the topics which follow.

The Tax Collection Agreement

It is clear that the present Federal-Provincial Tax Collection Agreement is an inhibitor, rather than an enabler, to change. Once the purpose(s) of the PIT system has been crystallized, the extent of change necessary to the Tax Collection Agreement may be determined.

While formal discussions have commenced to "open up" the Agreement to satisfy provincial demands for greater flexibility, the federal government has already given indications that the degree of change it is prepared to accommodate may be less than what the provinces are seeking. In Ontario, for example, should the province wish to use the Tax Collection Agreement to advance Ontario's social agenda, some policies (e.g. same-gender legislation and

common-law relationships) are not recognized under the federal Income Tax Act. This would inhibit Ontario's ability to initiate personal income tax changes for these groups of taxpayers.

If federal authorities are not prepared to accept the full extent of change requested, provinces must either accept the limitations offered within a revised Tax Collection Agreement, or withdraw from the Agreement and establish separate provincial PIT administrations.

Establishing a separate Ontario PIT administration would involve many considerations. Within these considerations is the matter of time necessary to implement such a large-scale change. Without specific analysis, it is difficult to estimate the lead time required. However, it is conceivable that such a change may take up to three years to complete. Other considerations of costs, both to government and taxpayers, as well as complexities of compliance and administration are also important factors to be weighed.

Rationalizing the Tax and Transfer Systems

While the SARC report identified some of the incongruities between the tax and transfer systems, its recommendations for improving congruence were aimed at the policy development process at the bureaucratic level, ie. improving compatibility between tax and social assistance policy design. The need to relate tax and transfer issues before finalizing policy changes in either field identifies the requirement, but gives no insight into how a more rationalized delivery system might be accomplished.

Under present circumstances within the PIT system, definitions and amounts of income, deductions, and non-refundable tax credits are determined by Revenue Canada, Taxation under the terms of the Tax Collection Agreement. This means that, should Ontario wish to establish more compatibility between the tax and transfer systems in these areas, the province would be required to revise transfer program features to conform with federal definitions and amounts. This may be unacceptable to the province.

Certainly the degree of compatibility between the tax and transfer system achieved in Quebec would not be possible in Ontario. The degree of provincial autonomy required to do so is prevented by the present provisions of the Tax Collection Agreement. While possible, it is difficult to envisage that the federal government would accommodate the degree of change required for such compatibility to be achieved under any revised version of the Tax Collection Agreement.

A significant obstacle, as well, is the limitation on information exchange between the two systems. As mentioned previously, strict restrictions on the use of personal income tax data, vital to a more rationalized tax and transfer payment system, severely impair a better co-ordinated approach. While Quebec has the authority to allow such interchange between the Quebec provincial personal income tax system, which it administers, and Quebec social program administration, this approach is expressly forbidden to Ontario. To do so would constitute a major breach of the Exchange of Information Agreement, the vehicle by which the federal government shares information collected from Ontario taxpayers. This matter could be added to Ontario's discussion agenda during federal-provincial negotiations.

One additional factor should be considered. Even with all other conditions being favourable, a highly-rationalized or fully-integrated tax and transfer payment system may require a major re-structuring of organizations and institutions currently involved in transfer payment program delivery. This rationalization would need to be linked to the PIT system. While the tax administration is centralized in one provincial ministry, transfer payment program delivery is much more fractured. In addition, the design, policy and delivery features of social programs and tax programs will need first to be harmonized, before any rationalization or full administrative integration could be contemplated. The advanced sophistication of the Ministry of Revenue's delivery systems may be of particular advantage in this regard.

The Quebec experience provides some useful insight for Ontario policy planners. Although the Quebec White Paper was published in 1984, the implementation of its strategic direction and proposals are ongoing even today. Perhaps from a perspective of implementation, a steadfast commitment to a strategic direction is of higher priority than the specific timetable for achieving all elements of the strategy. This may provide some comfort in view of the breadth and depth of dimensions which are associated with an undertaking of this magnitude. Maintaining gradual increments of change may be more achievable, durable and successful than large-scale changes within a shorter period.

Federal-Provincial Relations

At a higher plane, there are very significant implications in the arena of federal-provincial relations. All afore-mentioned considerations must be contemplated within a larger context. Present federal-provincial negotiations on a revised Canadian constitution, involving a re-defined distribution of federal and provincial powers, on issues of national unity and the future of Canadian federalism, and on future federal-provincial cost sharing arrangements may influence, or be influenced by, the issues identified in this paper. It is important that future objectives of compatibility between the tax and transfer systems be considered within the larger public context. While this makes reaching conclusions more complex, not to broaden the dimensions of consideration may render decisions incoherent with other related public policy issues.

Conclusions

Clearly, Ontario faces considerable challenges and significant constraints on provincial autonomy and flexibility in meeting these challenges. In the near term, it would appear unlikely that any significant movement towards better rationalization, let alone integration, of the tax and transfer systems could be achieved.

Charting a strategic future course is a multi-dimensional challenge. Each stakeholder in the decision-making process will, undoubtedly, apply differing weights to the various criteria in the evaluation of options. Reaching a broad base of public consensus would require extensive consultation and discussion to bring all relevant issues to the required level of public awareness. Such a process itself is time-consuming by nature. Still, it may be the only way to achieve a public policy decision that has a broad base of support and, therefore, has a reasonable prospect of durability over time.

APPENDIX A

PRINCIPLES OF TAXATION

Introduction

The following principles and descriptions have been extracted from Chapter I of the **Report of the Ontario Committee on Taxation**, published in 1967. These principles remain as guiding tenets of tax systems within constitutional democracies.

Constitutional Democracy, Economic Policy and Taxation

There are at least five major economic objectives that are generally recognized as falling within the purview of government.

1. a high and stable level of employment, which is not only essential to the most efficient use of available productive resources, but is also a basic foundation of human welfare and dignity;

2. reasonable stability of the general price level, a fundamental condition for economic efficiency and highly important to the achievement of equity and the protection of savings;

3. economic growth, defined as a rising per-capita annual production of goods and services, a process vital to continuing improvement in the standard of living - improvement that makes possible wider choices over the entire range of public and private goods and services;

4. an equitable distribution of income, necessary not only to provide incentives and to ensure the basic right of all individuals to a minimum level of economic and social well-being, but also to prevent undue concentrations of private economic power and to lessen the severity of cyclical swings in the level of economic activity; and

5. the promotion and regulation of competition, with a view to furthering the healthiest possible market economy.

The Principle of Equal Treatment of Equals (Horizontal Equity)

The basic rule of equity in taxation is the principle of equal treatment of equals (horizontal equity). This principle is basic because it is derived from the equality of individuals before the law, a person's fundamental right. Furthermore, it is applicable to all types of taxation, since all taxes are ultimately paid by the individual. To be sure, a substantial proportion of taxes are paid in the first instance not by individuals but by incorporated enterprises which have a legal identity apart from their owners.

In the long run, however, corporations are simply intermediaries for collecting revenues from individuals, whether as consumers , owners or employees. In exceptional circumstances, a tax

may be shifted in entirety to the consumers of a firm's product, or to the owners of the enterprise, or to the suppliers of labour and other resources employed by the business. More commonly, the tax burden will be shared among these interests, the proportion of sharing being related to market conditions and to the period of time within which the shifting takes place.

Whatever the case, the upshot is that since all taxes are ultimately paid by individuals, the principle of equal treatment of equals is a relevant consideration and its application should look beyond the entity on which the tax is first imposed to the individuals on whom the burden of tax finally rests. An over-reliance on taxes whose ultimate burden is difficult to trace is highly questionable from the standpoint of equity.

From the premise that equals should be treated equally, it is generally conceded that unequals should be treated unequally. At this point, it will be observed that two time-honoured principles apply to the unequal treatment of unequals; namely, the principle of benefits received and the principle of ability to pay.

The Principle of Benefits Received

Under this principle, achieving equity requires that the burden of taxation be allocated among taxpayers in relation to the benefits each derives from the enjoyment of public services. Its private sector equivalent is that goods and service should be paid for by their users.

In theory, the most useful interpretation of the benefit principle is that the cost of providing a public service should be allocated among individuals according to the marginal (additional) benefit that each person receives from that service. A willingness by the beneficiaries to support a new service on this basis of cost sharing will then reflect the fact that they have equated the marginal benefit from the service in question with the marginal sacrifice involved in paying for that service. At this point an optimal allocation of resources between the individual's public and private wants will have been achieved. In practice, it is impossible to apply the benefit theory with the above degree of precision because marginal benefit to each beneficiary cannot be measured directly.

Taxation according to the benefit theory has an important role in a fiscal system. Taxes based on benefit are desirable first, when the benefits and beneficiaries of government expenditure programs can be identified relatively clearly; second, when a modified distribution of wealth and income is not a policy objective; and third, when the imposition of benefit-related charges on the users or beneficiaries of a service will not result in an inefficient use of that service.

It is evident that the above conditions restrict the application of benefit-related taxation to a portion of the revenue-raising activities of government. Accordingly, the principle of ability to pay, the second approach to achieving equity in taxation, and the major pillar of most modern taxation systems, is used.

The Principle of Ability to Pay (Vertical Equity)

Under the principle of ability to pay (vertical equity), equity requires the equal treatment of persons possessing the same capacity to pay taxes. Ability to pay is appropriate for financing that great portion of government expenditure where it is either impossible or inappropriate to allocate cost among taxpayers in accordance with benefits received. The application of the ability to pay principle, however, requires agreement on some generally accepted criterion or criteria by which capacity to pay taxes may be measured.

Historically, ability to pay has been variously based on wealth, property ownership, and consumption. In modern economies, income is accepted as the prime index of tax-paying capacity. At the same time, wealth and consumption are essential components of a tax system based on a notion of balanced tax-paying capacity.

The key ingredient to the ability to pay principle is the concept of progressivity of taxation according to income level. The personal income tax system generally incorporates basic exemptions that recognize minimum income standards below which no tax should be levied. These exemptions can be tailored to recognize the need for minimal levels of income and the existence of different family responsibilities for maintaining dependents. Above the basic exemption level, rates of personal income tax can be made to vary in increasing proportion as the level of income rises. Thus it is said that the personal income tax is widely acclaimed as the tax most in accord with the principle of ability to pay.

It is also the case that the specific rates of progressivity in the personal tax system are driven more by social judgement that scientific principle. The progressivity of the tax table is determined by the expenditure needs of government, which in part is determined by the minimum standard of living as set by the state. This standard of living, to which individuals and families are deemed to have a social right, must take into consideration all sources of income available to individuals and families and the appropriate mix of revenue-gathering instruments. Personal income tax progressivity rates are then set to produce the required revenue levels.

The Principle of Adequacy

To be satisfactory, a tax system must be capable of providing the flow of funds that a government deems necessary in any given period.

The Principle of Flexibility

Flexibility of a tax system requires that it be so constituted that government, by discretionary action, can readily increase or decrease the flow of tax funds in response to changing circumstances. Such circumstances can stem either from considerations of expenditure requirements or of economic policy. Since some taxes are more flexible than others, the principle of flexibility can thus be deemed to be satisfied if a revenue system is comprised, in part, of flexible taxes.

The Principle of Elasticity

The premise of this principle is that a revenue system be composed in part of taxes whose yields respond closely to changing economic circumstances without deliberate changes to rates. Elasticity enables governments to meet rising service demands occasioned by economic growth without the disturbance of frequent tax rate changes. Elastic tax yields are also an important adjunct to fiscal policy in that they can serve as automatic stabilizers, leaving a greater proportion of income in the private sector in times of adversity and dampening inflationary pressures in times of prosperity.

The Principle of Balance

Sometimes referred to as "multiplicity" or "plurality", balance in a tax system is based partly on requirements of flexibility and elasticity, partly on equity, and partly on administrative considerations. Some taxes are more flexible; others are more elastic. With regard to equal treatment of equals, a reasonable degree of tax multiplicity is required to ensure both that differing individual situations are taken into account and to avoid the prospects of tax evasion associated with a single-tax system.

The Principle of Neutrality

Neutrality applies the rule of least price distortion in the choice of taxes. Since the pattern of relative prices determined by competitive market forces tends to encourage the most efficient allocation of the nation's resources, then to the extent that a tax system minimizes its distortion of relative prices, it minimizes its interference with productive efficiency.

A general tax, such as one on income or retail sales, will normally interfere less with individual choices on the part of producers, resource owners and consumers than would a selective excise tax applied to a narrow range of commodities. The principle of neutrality, as it relates to least price distortion, is violated if consumers are taxed for goods but not for services. Likewise, governments which provide tax concessions in order to induce particular firms or industries to locate in areas where, in terms of the most efficient use of resources, they would otherwise not go, are violating the principle of neutrality.
Again, neutrality would be violated where the revenue system imposes heavier taxes on some legal forms of business organization than on others.

Strict adherence to the principle of neutrality is appropriate only when economic efficiency is a prime criterion of policy. On frequent occasions, governments are legitimately more concerned with other goals and will consciously depart from neutrality in order to further these objectives. However, it should be recognized that where tax neutrality is abandoned, the efficient allocation of resources, in the short run at least, will be impeded.

The Principle of Certainty

Certainty relates to the time, manner and amount of payment of tax. A further argument for certainty is the desirability, in an era of high government expenditure, that the citizen be well informed of his tax burden so that he may relate it to the benefits he derives from public services. If the individual is not well informed, he may make decisions about government spending that might have been different had he been aware of the facts. A particular risk is that being only dimly aware of his total tax burden, he will underestimate the cost of the public services with which he is provided. This will be particularly likely where many of his taxes are hidden in the prices of the goods and services he purchases, rather than imposed upon him directly.

Certainly implies that direct taxes that cannot be shifted, or those that can be shifted only to a limited degree, are superior to any taxes that are hidden or easily shifted. On this basis, the personal income tax is superior to corporation income tax which sooner or later must be borne by individuals as consumers, shareholders or employees. Similarly, a visible retail sales tax is superior to a consumption tax levied at the manufacturer's level. Again, as it affects the relative merits of subsidies or tax concessions as forms of government financial assistance, the principle of certainty favours subsidies, for their costs are more readily ascertainable to government and public alike than are the costs of tax concessions or exemptions.

Finally, the principle of certainty should apply with force to the content of tax statutes. At the very least, no tax law should be written in such a way that it contains provisions that the government either cannot or will not enforce effectively. An obvious example of such a provision can be found in the Ontario Retail Sales Tax Act which stipulates that residents of Ontario are liable for sales tax on goods bought outside but transported into the province for their use. To the extent that such a requirement is known to be the law but is not enforced, the reputation of the government as a law-maker, to say nothing of respect for the law itself, is imperceptibly lowered in the public esteem. The principle of certainty demands statutes that are at once enforceable and enforced.

The Principle of Simplicity

Indiscriminate striving for simplicity will yield statutes that leave too much unsaid and which can only be applied with a wide scope for administrative discretion - discretion that will unduly impinge on certainty. Undue simplicity may also make it impossible to recognize the varying circumstances of particular taxpayers. The principle of simplicity must be considered as dictating the greatest clarity within the limits set by certainty and equity.

It should be understood, however, that even after every effort has been made to apply the principle of simplicity in the sense indicated above, certain taxes, notably those on personal and corporate income, will be embodied in statutes that are irreducibly but still appreciably complex.

The Principle of Convenience

The principle of convenience is highly significant in relation to the time, place and manner in which a taxpayer is called upon to discharge his obligations. The use of instalment payments, source deductions for personal income tax, payments through chartered banks and other locations are all in accordance with this principle. The principle of convenience is more than a matter of good public relations. Its use simplifies compliance and reduces its costs, while increasing the speed of government cash flows and hence reducing the need for short-term borrowing.

The Principle of Economy of Collection and Compliance

The principle of economy applies both to the costs incurred by government in collecting taxes and to those incurred by taxpayers in complying with their tax obligations. For government, the lowest cost is the lowest cost consistent with equity and effective enforcement. Properly understood, the principle of economy requires the employment of competent public servants in sufficient numbers.

APPENDIX B

SUPPORT FOR THE WHITE PAPER: EXTRACTS OF QUEBEC PROVINCIAL BUDGETS 1984 - 85 TO 1991 - 92

Introduction

As mentioned in the body of the paper, the recommendations of the White Paper began to find expression in the Quebec provincial budget before the conclusion of public and parliamentary committee debates. Below are extracts of Quebec provincial budgets which identify specific elements relating to the recommendations and policy directions proposed by the White Paper. A perusal will reveal that the government of Quebec has maintained a steadfast acceptance of the thrust of the White Paper. Items in *italics* indicate measures which would be unavailable to Ontario due to restrictions in the Federal-Provincial Tax Collection Agreement.

1984-85 Budget - May 22, 1984

- White Paper introduced with a parliamentary committee to be convened in the fall to examine the report

1985-86 Budget - April 23, 1985

- *commencing January 1, 1986, basic personal exemption and married person exemption to become equal in three steps, concluding in 1988*
- *increased personal exemption for dependent children, extended to age 21 years, or over age 21 years if dependent child still in school*
- *Quebec family allowance payments retained but factored into income for tax purposes*
- *federal family allowances become taxable for children of all ages*
- *introduction of an additional exemption for students to recognize essential needs of students at post-secondary level*
- *age exemption retained, but not indexed, for retired persons*
- *special exemption for persons living alone to recognize essential needs of single dwellers vs. multiple dwellers*
- rationalization of property tax refund and property tax credit to ensure that each taxpayer qualifies for only one of the two
- introduction of a consumption tax credit, to offset the portion of income from essential needs spent on consumption taxes, reduced by 3% of income exceeding personal exemptions and deductions relating to employment

- *employment expense deduction increased from 3% to 6% to a maximum of $500 in 1986, $600 in 1987 and $750 in 1988*

- *child care expense maximums for children under age six years raised from $2,000 to $3,500 per child and reduced from $2,000 to $1,755 for children of school age, ending completely for children age 12 years and older, with taxpayer with highest income eligible to claim all child care expenses - all changes effective January 1, 1986*

- *lump-sum $100 charitable donation deduction eliminated effective January 1, 1986*

- *cost of essential needs to be indexed each year in same ratio as personal exemptions*

- effective January 1, 1986 marginal tax rates reduced beginning at the level of $17,360 of taxable income and introduction of minimum provincial income tax applicable to high income earners who would otherwise pay no income tax

1986-87 Budget - May 1, 1986

- *interest and dividend income deduction reduced to $500 from $1,000, with a similar reduction applied to the pension income deduction*

- availability allowance for children under age six years to be examined

- *recapture of the Quebec family allowance for the fourth child is abolished*

1987-88 Budget - April 30, 1987

- *low- and middle-income families receive graduated tax reductions, based on income and expenses, of up to $930 for two-parent families and $765 for single-parent families*

- two-parent families with two dependent children would pay no provincial income tax on income of $20,822 or less, up from $13,004; full use of the child care expense deduction raised the zero-tax threshold to $25,871 from $15,541

- effective January 1, 1988 a new assistance program for low-income families with children replaces the work income supplement program, with increased benefits

- recapture of the Quebec family allowance for the third child is abolished

- availability allowance rates changed for children under age six years - $100 for first child, $200 for second child, $500 for third and subsequent children, compared with previous rates of $300 for first child, $200 for second child and $100 for third and subsequent children

1988-89 Budget - May 12, 1988

- *introduction of refundable and non-refundable tax credits to replace personal exemptions and deductions to ensure fairness and conformity with federal tax reform changes (Quebec exemptions converted to a credit at 20% of exemption value vs. federal credit of 17% of federal exemption value)*

- *age tax credit of $440 established for elderly without employment income and $200 for elderly with employment income*

- *charitable donation exemption not converted to a tax credit*

- zero-tax threshold raised to recognize value of essential needs

- *non-recovery of Quebec family allowances*

- *new allowance for children under age six years*

- $500 additional allowance for new-born children

- $3,000 allowance for third and subsequent new-born children payable in $375 quarterly instalments until the child reaches age two years

- *16 provincial income tax brackets reduced to five, with maximum marginal rate on taxable income of $50,000 or more reduced to 24% from 28%*

- *maximum child care expense deduction for children up to age seven years (previously age six years) increased to $4,000 per child, and for children age eight to 13 years (previously age 12 years) increased to $2,000 per child*

- first $10,000 of income does not reduce entitlement to property tax refund

1989-90 Budget - May 16, 1989

- social aid benefits for mentally and physically disabled persons increased above the minimum level

- social aid beneficiaries under age 30 years receive the same benefit levels as persons age 30 years or older in similar circumstances

- introduction of Employment Incentives Program to smooth the transition of those on social aid back into the labour force

- amount for birth of second child increased to $1,000 from $500, with the second instalment of $500 to be paid on the child's second birthday

- for the third and subsequent new-born children, allowance raised to $4,500 from $3,000, paid in equal quarterly instalments over three years

- same level of taxation indexation as for social aid benefit indexation

1990-91 Budget - April 26, 1990

- income security scales and tax credits fully indexed to rise in cost of living effective January 1, 1991

- allowance for third and subsequent new-born children raised to $6,000 from $4,500, paid in equal quarterly instalments over four years instead of three years

1991-92 Budget - May 2, 1991

- allowance for third and subsequent new-born children raised to $7,500 from $6,000, paid in equal quarterly instalments over five years instead of four years

- changes to the **APPORT** program, which provides social aid to single-parent families, to improve food supplementary budgets and simplify calculation of benefits

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